Table 4 Comparing Binary Offshore Index and Binary Laxity determinants (130 countries and territories)

Dependent Variable	*Binary Laxity Index*	*Binary Offshore Index*
Landuse	0.007***	-0.002
	(0.003)	(0.005)
Gdpcapita	-7.07E-05****	-2.04E-07
	(1.92E-05)	(2.60E-07)
Fordepostcapita	3.18E-06****	1.71E-06
	(1.36E-06)	(1.33E-08)
Terrorismorgcrime	-0.508***	-1.888****
	(0.224)	(0.448)

STANDARD ERRORS IN PARENTHESIS. SUPERSCRIPT ASTERISKS INDICATE STATISTICAL SIGNIFICANCE AT 0.01 (****), 0.02 (***), 0.05 (**), 0.10 (*).

As can be see, with the exception of the crime and terrorism index, none of variables have any explanatory power. This seems to suggest that the underlying economic characteristics of offshore centres and our NCCTs tend to differ. In general, therefore, we can reject the hypothesis that the causes of lax financial regulation decisions and of offshore activities are exactly the same.

In conclusion, the non-cooperative attitude seems to be dependent on key structural features of the country. Now, what are the consequences of our analysis on the debate concerning the effectiveness of blacklisting procedures?

4. Conclusions. Is Blacklisting an Effective Device?

In this paper we theoretically discuss and empirically test the relationships between specific country features, policymaker choices toward lax financial regulation, and national non-cooperative attitude with respect to the international effort to combat money-laundering phenomena. Our results suggest two main prescriptions for designing international policies aimed at reducing the global risks of terrorism and organized crime. These prescriptions can help to identify a possible role for the G8 countries in combating black money.

First of all, a pure and just formal “name and shame” approach may even prove counterproductive. Assuming that the international community is capable of effectively singling out NCCT jurisdictions that are indeed involved in black money schemes, a cautious approach is still deemed necessary. When the international community points the finger at a given country as a leading supplier of money-laundering financial services, it may also be certifying, to the benefit of the country itself, that that country is indeed specialized in that business. The signaling effect embedded in the "name and shame approach" should not be underestimated. The main difficulty for a genuine LFR country is credibly solving the commitment problem. Then, what is a better choice for an LFR country than having the international community—not exactly its closest friends—solving that problem through a public statement certifying a non-cooperative attitude (*reluctant friend effect*)?

Listing should also be regarded as a sort of third party bonding, which is likely to generate two interacting effects. First, it is capable of cementing the commitment by the LFR country. Secondly, naming increases the transaction-specific nature of investments in reputation. Inclusion in a black list increases the value of the (sunk) investments in reputation. In terms of our analysis, for specific countries, the actual effect of the blacklisting procedures can be to increase the expected national benefits rather than improve international political enforcement. As we will point out later, other complementary countermeasures can be necessary to increase the expected costs of the non cooperative attitude.

Furthermore, a country that is engaged in money laundering and finds itself blacklisted will find it even more difficult to switch course and decide to exit the market, thus being encouraged to compete aggressively in the market. The final result does not change much. It still needs to move forward.

The second conclusion that can be reached based on the empirical evidence we have examined is that we must not exclude the possibility that there are LFR countries not presently included in the FATF monitoring action. This is true, perhaps, because they are highly effective in bringing their formal rules in line with international precepts, while in their deeds they remain lax in the fight against black money. By the same token, by modifying their formal rules former NCCT countries could not automatically cease to be lax countries, since the incentives for laxity in combating the laundering of illicit capital may be very deep-rooted (*false friend effect*).

This is not to say that the international community should not endeavor to list countries involved in the market for money laundering services. What this paper argues, is that a "name and shame" approach *per se*, separated from other initiatives, could not produce effective results. Names should be named, but only if blacklisting goes hand in hand with other measures.

Appropriate countermeasures that increase the actual level of international political enforcement and/or the level of international reputation costs should be grounded on the premise that in a global world even the most efficient LFR country will still need to be integrated into the world financial markets.

This implies that no matter how many layers of transactions cover the predicate offence, terrorism or criminal organizations will still need to place that money within the lawful financial sector. This step is necessary, at a minimum, to exploit the capital in lawful uses, once it has been laundered. Money laundering is by definition instrumental to a later use.

In this regard, there is one fundamental feature of the initiative taken by the FATF that appears to be pivotal for its success: the FATF has not limited its initiative to a mere recognition of "non co-operative countries and territories." FATF member states have also applied "Recommendation 21"[29] to the countries included in the list. "Recommendation 21" requires a higher scrutiny by financial intermediaries in evaluating the suspect nature of transactions with counter parties, including legal persons, based in a country listed as non-cooperative. As a result of the FATF initiative, many countries included in the list have already taken initiatives aimed at overcoming the serious deficiencies observed by the FATF.[30]
These initiatives need to be evaluated in the medium-to-long term, because some of the enacted laws, for example, will require the issue of secondary regulations to become effective, or, more generally, the initiatives taken at the legislative level will need to be followed by concrete actions. It can be argued, however, that the threat of being crowded out by the international community has played a key role in spurring the adoption of the above mentioned initiatives. However it may be the case to go beyond that. The international community could to consider the possibility to introduce effective punitive measures, as a *financial quarantine* for every country that did not adhere to the international standards[31]. The G8 countries could play the role of promoting a complete strategy to combat black money focused on the financial quarantine threat; it could be the effective stick to intertwine with appropriate carrots in defining a new "name and shame" approach.
Finally, the above conclusions imply a constant effort on the part of international organizations, particularly the FATF, to update the criteria and monitor the countries.

[29] See FAFT, (1990). (2000). In addition, on June 2001the FAFT agreed to a process of stricter countermeasures for reluctant NCCTs; see Norgren (2004).
[30] See FAFT press communiqué of October 5th, (2000).
[31] On the possible features of a financial quarantine see Tanzi (2000).

Annex I

Money Laundering and Terrorism Finance, Formal and Informal Finance: Key Concepts

Since 11 September 2001, the financial systems, overt and covert, have come increasingly into the sights of the state agencies appointed to combat terrorism. In that context, the need to increase the fight against the laundering of illicit capital was included in the agenda.

We should immediately stress that in terms of economic analysis the financing of terrorism (money dirtying) is a phenomenon conceptually different from the recycling of capital (money laundering).

To understand the similarities and differences, therefore, we must briefly review the economic peculiarities of the money-laundering phenomenon. In recent years, particular emphasis has been placed on the study of that phenomenon because of its central theoretical and practical role in the development of any crime that generates revenues.

In fact, the conduct of any illegal activity may be subject to a special category of transaction costs, linked to the fact that the use of the relative revenues increases the probability of discovery of the crime and therefore incrimination.

Those transaction costs can be minimised through an effective laundering action, a means of concealment that separates financial flows from their origin, an activity whose specific economic function is to transform potential wealth into effective purchasing power.

In this sense, money-laundering performs an illegal monetary function, responding to the demand for ‘black finance’ services expressed by individuals or groups that have committed income-producing crimes.

The financing of terrorism resembles money-laundering in some respects and differs from it in others. The objective of the activity is to channel funds of any origin to individuals or groups to enable acts of terrorism, and therefore crimes. Again in this case, a party with such an objective must contend with potential transaction costs, since the financial flows may increase the probability that the crime of terrorism will be discovered, thus leading to incrimination. Therefore, an effective money dirtying action, an activity of concealment designed to separate financial flows from their destination, can minimise the transaction costs. Thus, money dirtying can also perform an illegal monetary function, responding to the demand for ‘covertness’ expressed by individuals or groups proposing to commit crimes of terrorism.

The phenomena of money laundering and money dirtying may coexist, of course, when terrorism is financed through the use of funds originating from criminal activities. A typical example is the financing of terrorism with the proceeds from the production and marketing of narcotics. In those specific situations, at least on the logical level, the importance of the transaction costs is doubled, since the need to lower the probability of incrimination concerns both the crimes that generated the financial flows and the crimes for which they are intended. As a result, the value of a concealment operation is even more significant.

But who satisfies the demand for concealment, whether its purpose is money-laundering or financing terrorism?

Drawing upon the literature on information asymmetries, it is easy to demonstrate that banking and financial intermediaries can perform an important function in the concealment activity, whether the underlying motive is money-laundering or financing terrorism.

By reducing the overall transaction costs for the other economic agents, financial intermediaries improve the consumers' capacity to decide how to allocate their purchasing power in terms of consumption, savings and investment. Thus, intermediaries ultimately animate an industry in which the services offered and sold are intrinsically intangible, with an information content that is high but not uniformly distributed among all the market participants. The diverse characteristics of the operators are thus known to, and coordinated by, the financial firms through the supply and sale of their services, and the individual intermediaries seek to maximise their profit precisely through the management and enhancement of their information assets, in a sector where information is not uniformly distributed. Therefore, financial firms are ultimately characterised as having information assets greater than, different from and more specialised than, all the others. As a result, the financial industry acquires a reputation for two crucial attributes with regard to the purpose of concealment: a greater-than-normal degree of 'opacity' (information asymmetry), since the exchanges and flows of purchasing power are filtered, coordinated and administered by specialised operators; the privileged position of those intermediaries.

It should be stressed, however, that the connotation of incomplete, asymmetrical distribution of information between the parties stipulating the various forms of contract or agreement is accentuated in the provision of financial services but is not the exclusive prerogative of those markets. It manifests itself, for example, when the characteristics of the provision of professional services are examined. In any case, the quantitative and qualitative centrality of the financial industry within the overall economic system clearly evidences information asymmetry and centrality of the specialised operators.

Within the financial sector, a particular role is played by banks, intermediaries distinguished by the simultaneous offering of a) deposit contracts, fungible for payment and monetary requirements, and b) credit contracts, generally not transformable prima facie into market-negotiable assets. Banks thus emerge as a 'special' intermediary, since both their deposit and loan contracts provide them with significant economies of scale and diversification in the management of information. In markets 'opaque' by definition, they therefore become a depositary of confidential information on both the beneficiaries of loans and on the users of payment services, or whatever services they provide.

Management of the payments system also puts banks in a crucial position regarding the purpose of concealment. The more a payments system minimises the costs that operators pay to transform their potential options for allocating purchasing power into actual options, the more efficient it becomes. But, if this is true, that system can be a potentially optimal, efficient vehicle for transforming the potential purchasing power of illicit revenues into actual purchasing power and therefore for performing money laundering functions effectively. At the same time, through the payments system, the provision of funds to terrorist organisations can be concealed.

In other words, management of the payments system has a positive value for legal economic agents, since it facilitates their resource allocation decisions. At the same time, it may be crucial for illegal parties, which are seeking not only to reduce transaction costs but especially to minimise the risks of discovery – and therefore the costs of sanctions and punishment – associated with both money-laundering and terrorism financing activities.

Banking and financial intermediaries are therefore at the centre of attention of both criminal and terrorist organisations and the law enforcement authorities. For criminal parties, the presence of intermediaries that are cooperative (contaminating intermediaries) or inefficient in protecting their integrity (unknowing intermediaries) increases the possibility of using the payments or lending systems, or financial services system in general, for their concealment objectives. At the same time, for the inquiring and investigative authorities, the information assets in the possession of those companies can serve an essential reporting function in the identification and verification of the presence of criminal or terrorist organisations or individuals.

To cast light on the similarities and differences between money laundering and money dirtying, we should dwell on the role of the unknowing intermediaries, to which the authorities assign the task of reporting suspicious financial movements.

Starting with money-laundering phenomena, we reconsider the definition of money laundering with respect to any financial transaction: that transaction not only performs an economic function of its own but, if its purpose is to launder funds, it also performs an additional irregular function.

The hypothesis is that precisely because the transaction in question is responding to an uncommon (and illegal) purpose, it will possess irregular features that distinguish it from normal, physiological characteristics. What will the sources of the irregularity be? The irregularity could arise from at least one of the base-elements of the definition of money laundering, in which an economic agent institutes procedures to transform a given amount of potential purchasing power into actual purchasing power. The irregularity could therefore refer to at least one of the three elements: the party, the procedures and the amount of a given banking or financial contract.

Thanks to past evolution, money-laundering techniques now pose greater difficulties of identification and monitoring, precisely because they have made concealment and the separation of the three components of a laundering operation increasingly effective. A first important point is therefore the growing difficulty of recognising money-laundering irregularities. A second important point is the fact that a banking or financial transaction may embody irregular elements without this signifying that it derives from a laundering attempt: irregularity can therefore be considered a necessary but insufficient condition for identifying money-laundering activity.

These reflections on the logical and operational difficulties related to the hypothesis of irregularity are strengthened when this postulate becomes the cornerstone on which the obligations of intermediaries to collaborate in the war on the financing of terrorism are based. It is wholly evident, in fact, that the existence or detectability of irregular elements can become even more problematic when the sources of the financial flows to be concealed are totally licit activities conducted by individuals or organisations equally overt and legal.

In summing up our analysis regarding the relationship between the laundering of capital and financing terrorism, one is prompted to think that the operational techniques, and therefore the channels of dissemination, of the two phenomena are at least in part coincident. It is important, however, for the partial coincidence of money dirtying and money laundering to remain a working hypothesis rather than a theorem, so that it is possible to attempt the construction of a system of rules that can combine the effective enforcement of laws with the efficiency of the banking and financial markets.

And it is precisely from the standpoint of possible channels for financing terrorism that the theme of informal finance emerges, although it is not a new concept.

The focus on the relationship between informal banking and financial systems, on the one hand, and the potential risks of money laundering and terrorism financing, on the other, is quite recent, and the few studies on the subject are exclusively descriptive in nature.

From the standpoint of economic analysis, the description of those systems leads us to conclude that those informal networks, beyond the obvious historical, geographical and technical-operational differences, seem to be distinguished by the following: informality and trust on an ethical basis.

Informal finance systems, in fact, develop without the stable or long-lasting support of a system of formal laws, administrative rules, and relative documentary, paper-based records, as is characteristic of formal finance systems, bank-based and otherwise. The fuel and catalyst of these systems is ethics-based trust: in individual communities, strongly identified on the ethnic level, financial transactions are carried out that create *de facto* debtor–creditor relations of variable duration on the basis of a common fiduciary heritage. In informal systems, the reliability of these relations cannot be based, by definition, on the threat of legal sanctions but rests instead on the advisability of avoiding the social and moral sanctions that strike members of the reference community who fail to fulfil their obligations, with highly concrete effects associated with exclusion and isolation.

The systems of informal finance thus seem to be heavily used by migrants belonging to the ethnic communities from which these systems originated. This observation is obviously not based on robust statistical series, given the covert nature of the phenomenon, but on a growing volume of specific case studies and on specific sample surveys.

The combination of high fiduciary content and ethnic affinity makes those informal, naïve channels – consisting of networks among friends and relatives of the same ethnic group as the immigrant or by more complex structures of informal finance – particularly attractive. The use of ethnic-national networks is strictly tied to the strength of relationships of trust among immigrant compatriots.

Informal finance is characterised by great simplicity and rapidity of procedures, operational flexibility, and a capacity to adjust to the needs of the migrants. Informal finance also displays maximum capacity in integrating the economic element into the social context and in linking organisational decisions to cultural influences and traditions. The operations of informal financial institutions are based on trust and on gradually established schemes and procedures and customary rules. The functioning of informal finance mechanisms is normally ensured by 'social control', i.e. the censure of improper conduct exercised by the community through the marginalisation of migrants who fail to adhere to the rules (typically ethical or religious rules linked to the cultural background). It is not rash to maintain, in fact, that the mechanism for enforcing the relations created within informal networks is repeated within the local immigrant communities, which are particularly sensitive to cultural identity and relative 'marginalisation risk'.

The assurance of confidentiality and the minimal request of information are known to be crucial aspects of the banking and financial industry, and become even more so where some specific customer characteristics are present: illegal immigrants; legal immigrants but with little clarity/legality regarding their social-security, employment and residential positions; legal immigrants with a preference for informal channels for regulatory reasons (fiscal aspects, rules on currency flows, etc) in the country of origin; legal immigrants who, for psychological motives, dictated by the social context of the host country, desire minimal visibility and do not appreciate any type of control or disclosure of personal information.

In the relationship between informal finance and migrants, in essence, we find yet another example of the now-classic lesson of recent economic analysis: exchanges occur only where there is information and sufficient trust. In effect, the capacity of the informal systems to succeed where the formal systems tend to fail has been explored by economic analysis, particularly regarding credit mechanisms.

Under certain conditions, therefore, the informal systems are more efficient than the formal systems. Unexplored, on the other hand, is the relationship between covertness and integrity, in terms of the risk that these channels may satisfy the demand for illegal financial services, and particularly serve for purposes of money-laundering and financing terrorism.

Based on the considerations advanced earlier regarding the characteristics that make a system attractive to those individuals or organisations wishing to conceal the origin or destination of given monetary flows, it seems evident that informal finance may appear particularly effective with respect to these purposes.

Both money laundering and money dirtying are based on a need for concealment. Informality, other conditions being equal, reduces the traceability of both the origin and destination of the financial flows. While the sharing of common fiduciary assets also imposes confidentiality, or better secrecy, the impermeability of informal systems to the acquisition of information by outsiders is greatly reduced, especially if the outsiders are authorities, and all the more if they are representatives of foreign countries. Therefore, at least at the level of deductive reasoning, the riskiness of informal finance systems, in terms of their use by criminal or terrorist organisations, seems greater than that attributable to overt finance, banking and non-banking.

Annex II

Lax Financial Regulation: Key Concepts

The relationship between money laundering and national financial regulation is key issue in the international debate. To discuss this issue from an economic point of view it can be useful to treat the regulation of money laundering as a product, with a demand and supply schedule. But whose demand schedule is driving the system?

We assume that the policymaker in a given country has not yet decided the direction that it will impose on its financial regulation, with specific regard to money laundering. The policymaker may thus decide to implement regulations that create serious obstacles to money laundering, and thus to terrorism and organised crime, or it may decide – at the other extreme – to make the opposite choice, devising lax regulations that facilitate money laundering.

Money laundering generates costs as well as benefits for the parties involved. The costs for society depend on the fact that more predicate offences will be committed by terrorist or criminal organisation if money laundering is possible, and on the possible negative impact that money laundering will have on the economic system.

The benefits of money laundering accrue, first of all, to terrorist and criminal organisations, which can employ the proceeds of crime and avoid the threat of prosecution for predicate offences (money laundering in the strict sense), or which can use legal capital to finance illegal activities (money dirtying). The similarities and differences between money laundering and money dirtying were discussed above and in Annex I.

On the other side of the transaction, money laundering offers the host country the possibility to earn a 'commission' in exchange for its services – what we can call *the expected national benefits* due to lax financial regulation.

Therefore, we can identify four different categories of actors potentially interested in regulation: a) the policymakers; b) terrorist and criminal organisations, deriving utility from the possibility of laundering money; c) those who bear the costs of money laundering; d) the financial community and, in general, the citizens that receive benefits from the inflow of foreign black and grey capital.

Starting with this last category, it seems difficult to predict which side the financial community will take. In general, we tend to think that the utility function of financial intermediaries does not appear to be affected by whether profits stem from legal or illegal financial activities (*pecunia non olet*). We think that they simply maximise the expected revenues, and that, given the asymmetric information issues, they are not able to distinguish clearly the customers' nature, legal or illegal.

The interests of b) and c) are obviously incompatible, as the gains of the former depend on the losses of the latter; a) appears to be caught in the middle, having to decide which demand schedule to follow.

Note that we are not assuming that b) and c) are necessarily based *outside* the country where the policymaker we are concerned with is based. This is not an assumption, but rather the consequence of our line of argument. As with all policy issues, as long as the costs and benefits of a decision fall within the boundaries of the area of influence of the policymaker, we expect to have an efficient decision. Policymakers in countries where crime or terrorism is pervasive will tend to bear at least some of the costs associated with a decision to favour money laundering.

Countries where organised crime or terrorism is pervasive might appear to play a minor role in the offer of black or grey financial services at the international level, because they are sensitive to terrorism – and crime – related national costs. This might be so because the widespread presence of organised crime or terrorism in the country increases, for the policymaker, the costs of regulations that favour money laundering.

The public will bear the costs of the decision and will hold the policymaker responsible. Entering the international market for money laundering services has a greater potential for countries that are immune from terrorist or criminal activities. By definition, such countries will almost be able to externalise the costs associated with the increase of predicate offences. A negative correlation between crime rate or terrorist episodes in the country and the role played in the offering of money laundering services appears likely.

As a result of this process, some countries which do not bear the costs associated with money laundering become predisposed to adopting lax regulations that facilitate money laundering. The other side of the coin is that both criminal and terrorist organisations and those who bear the costs stemming from money laundering will 'naturally' tend to be situated in countries other than the one where the regulations are adopted.

We have thus limited our attention to policymakers that are based in countries different from those which the other actors potentially interested in the regulations are based in. From this starting point, the confrontation between those who benefit from money laundering and those who suffer from it is almost a 'win-win' game for criminal and terrorist organisations.

Organised crime and terrorism enjoy huge asymmetrical organisational advantages over those who bear the costs of money laundering. A small, powerful group opposes a large, dispersed group, thus making the outcome predictable.

To be sure, money-laundering regulation could be opposed, and indeed is opposed, by political authorities that represent the public interest. The dispersion of the costs, however, makes money laundering a low salience issue for the public, and consequently quite low on the political agenda. The man on the street simply does not feel the bite of money laundering, and political actors will act as a consequence.